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The newsletter of the ISBA's Section on Federal Taxation

Chairman's corner

By James S. Zmuda, Califf & Harper, P.C., Moline

I have had the privilege of membership in the Federal Taxation Section Council for a number of years. The Section Council provides a forum for discussion of current tax issues among practitioners, an avenue for keeping you, the members, informed of current tax developments through this, our newsletter, and the important function of having a role and potential impact in the development of federal taxation legislation.

One of the highlights of the Section Council's yearly activities is what has become an annual discussion in Washington, D.C. with key legislators concerning major issues of federal taxation. The Section Council's annual presence in Washington has met with considerable favor and we have received substantial encouragement regarding our activities. Our goal is to engage policymakers and those who advise them in meaningful discussion about pending and proposed legislation as well as areas ripe for reform. Certain of the Section Council's proposals have found their way to law. We have been encouraged to present as many real life examples as to the impact to federal taxation legislation as possible to aid in development of future tax legislation and reform of current tax legislation.

While our contact with Washington has historically been limited to our annual passage to the Nation's capital, in recent years my predecessors, as Chair of this Section Council, have succeeded in further opening the channels of communication beyond the single annual face-to-face meeting.

My primary goal as Chair of this Section Council during my tenure is to further the work of my predecessors, and utilize each Section Council meeting as an opportunity to arrange for the participation of a prominent tax policymaker to participate in our Section Council meetings. I anticipate meaningful roundtable-type discussions about various tax issues relevant to members of this Section Council.

Like my predecessors, I would encourage each of you to participate in any of our Section Council meetings. You may contact either myself at jzmuda@califf.com or our Newsletter Editor, Thomas Arends, at tarends@colombik.com for the schedule of upcoming meetings. At each meeting, you can expect a timely and topical discussion of key tax issues.

I look forward to the opportunity to serve you, the members of the Federal Taxation Section, during this year. I strongly encourage your participation and am interested in your thoughts and suggestions as to how we might better serve you.

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Minimizing risk in taxable portfolios: Initiating and closing out derivative transactions without unexpected tax consequences

By Randall H. Borkus, Richard M. Colombik & Associates, P.C., Schaumburg[1]

Financial derivatives provide insurance and wealth protection for taxable portfolios. Derivative instruments are complex risk management tools that require knowledge of stochastic calculus algorithms and theorems to establish accurate pricing.[2] However, risk management requires more than understanding higher mathematics; it also requires an understanding of the tax consequences. Failing to plan for tax consequences will inevitably come back and bite taxpayers who use derivatives products for wealth preservation and succession planning. Therefore, tax planning is a mandatory factor in any risk management analysis.

Historically, when a security or a bond is sold, the tax consequence is a straightforward computation contingent upon the holding period and the capital gains are offset by capital losses. However, where a security or a bond is

hedged with a derivative instrument (the "hedge"),[3] tax consequences become far less straightforward. One major complication is that the eventual selling price of the underlying instrument for which a hedge is initiated remains an unknown because the final price of the underlying is determined in the future. Therefore, whether a taxpayer is an individual investor, professional investment manager, trader or fiduciary (hereinafter collectively referred to as "taxpayer"), understanding tax consequences is a key ingredient to fully analyzing a hedge. "[A] hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to manage risk."[4]

Hedges are largely influenced by two tax rules: upon initiation of the hedge the constructive sale rules under IRC 1259 and the straddle rules under 1092 when closing out the position. The constructive sale rules are used to determine whether initiating a hedge will be construed as a sale of the underlying security. Where a constructive sale is deemed to have occurred, the transaction results in the recognition of capital gains even though an actual sale of the underlying asset has not occurred.

The straddle rules govern the tax consequences of closing out a hedge. A straddle occurs where a taxpayer has offsetting positions with respect to personal property. The effect of the straddle rules are to toll the capital gain period, capitalize carrying costs and limit the amount of losses a taxpayer may use against gains in a given year. Both rules must be planned for when a taxpayer implements a derivatives transaction that is part of a wealth preservation or succession plan.

Implementation: Constructive Sale Rules

When a taxpayer wishes to protect capital appreciation of an asset he or she holds, understanding the constructive sale rules is the first step. The 1997 Tax Reform Act added IRC §1259 for the purpose of providing that certain transactions, which neutralize gain and loss in a current stock holding are "constructive sales," which cause recognition of gain.[5]

A constructive sale results when the taxpayer holds appreciated property and initiates (1) a short sale of the same or substantially identical property; (2) an offsetting notional principle contract (such as a swap) with respect to the same or substantially identical property; (3) or a futures or forward contract to deliver the same or substantially identical property.[6] Moreover, a constructive sale includes other transactions with substantially the same effect such as option transactions. The term "substantially identical" generally is considered securities issued by the same issuer that are commercially identical.[7]

Strategies for Circumventing Constructive Sale Rules:

Initiating a protective put[8] strategy should not subject the transaction to the constructive sale rules even where a put on the same underlying asset. Unfortunately, no final regulations have been issued to clarify what is and is not a constructive sale. The Congressional committee report regarding the 1997 Tax Reform Act suggests constructive sale treatment applies to strategies which eliminate nearly all gain and loss,[9] whereas a protective put strategy generally reduces some loss risk, but reduces little, if any, gain.. However, in the case where a put option is "deep in the money," the service could argue that the put is a constructive sale because the price correlation between the put and the underlying asset becomes close to one.[10] For example, when the price of the underlying stock is $9, a put option on that same stock with a strike price of $10 will increase in price at a ratio of approximately one-to-one as the stock price moves lower. This "deep in the money" put option price will move to effectively offset all loss and arguably be a substantially identical asset as a result.

Next, short selling a stock or stock index which the taxpayer holds triggers the constructive sale rules in most instances. Conversely, short selling a stock or a stock index not otherwise held by the taxpayer is not a constructive sale because this transaction avoids the problem of shorting a substantially identical asset. For example, the taxpayer holds an appreciated position in Intel stock and short sells Microsoft stock to hedge against the price decline in Intel. This is not a constructive sale because though the stocks are in comparable industries,

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they are not substantially similar.

CAVEAT: This strategy works well to avoid the constructive sale rules, but the Microsoft hedge may lack the sufficient correlation to adequately protect against severe price declines in Intel stock.

Another strategy to avoid constructive sale rules is the execution of a collar. A collar provides for a combination of loss and gain in the same transaction. However, where the collar transaction too closely freezes the stock price within a relatively tight range, the transaction may be determined to be an "abusive collar."[11] Collars should avoid an "abusive" designation where the term is three years or less and the difference between the floor and ceiling price is approximately 20 percent.[12] It is commonly believed that non-abusive collars should be grandfathered in under the final regulations.[13] The final regulations covering constructive sales are on the IRS' agenda; however, that has been the case for sometime.[14] Therefore, when a taxpayer attempts to manipulate both the gain and loss potential on an underlying asset, which is exactly what a collar accomplishes, the transaction must be carefully analyzed.

Still another popular hedge that provides a taxpayer with great flexibility is a debt exchange for common stock or a prepaid forward variable sale ("PFVS").[15] A PFVS has characteristics similar to a collar. However, in addition to providing a hedge, the PFVS allows the taxpayer to borrow in excess of the standard 50 percent in a margin account.[16] Furthermore, these contracts are not required to be exercised in the future because this instrument can be cash settled; thus, no taxable sale of the underlying asset commences.[17]

> [PFVSs] are designed so that purchasers contractually agree to sell their equity position at a predetermined date while receiving cash immediately. The transaction settles when the purchasers deliver a variable number of shares equivalent to the stock's closing value at an agreed upon maturity date. The number of shares at delivery will equal the economic equivalent to the full amount of down-side protection with the purchaser maintaining the capital appreciation of the position up to a capped amount.[18]

The PFVS enables the taxpayer to avoid a constructive sale[19] and defer tax consequences because the underlying shares are not delivered until the exercise date. Moreover, cash settling the contract averts a sale of the underlying and the tax consequences that would otherwise accompany such a sale.[20]

There are other strategies as well as limited exemptions from the constructive sale rules, but a protective put, a short sale against a similar but different stock or index, a collar and a PFVS, are the most frequently used strategies which circumvent the constructive sale rules.

Closing Out the Hedge: Straddle Rules

Next tax factor to consider is the impact of the straddle rules. A typical straddle transaction is an investment in financial instrument "A" that offsets an existing investment in financial instrument "B" for the purpose of limiting the price risk of instrument "B." In a straddle transaction, a change in the market value of instrument "B" normally results in an inverse reaction in the value of instrument "A," not necessarily on a one-to-one basis, but still significantly enough to minimize the loss risk in instrument "B."

Most straddle transactions have legitimate business purposes, particularly when implemented by farmers, food producers or manufacturers whose profits are susceptible to volatile price swings. However, to ensure that only hedges with legitimate business purposes are implemented, the amount of realized loss from one financial instrument is limited and its timing shall be related directly to the recognition of gain on a corresponding or offsetting asset. Abuse can occur when a taxpayer realizes a loss in one security while holding an offsetting gain in another security.[21]

> A typical abusive straddle involves the acquisition of 'deep-in-the-money' offsetting positions.[22] Regardless of whether the value of the underlying stock increases or decreases, one option position will result in a loss that can be realized for tax purposes, while the other position results in a gain of approximately equal size that can be deferred until the next year. Adopting a new offsetting position to replace the loss position that is disposed of can preserve the unrealized gain.[23]

Congress implemented IRC §1092 to prevent this result with respect to straddles.

Basic Straddle Rules

The Internal Revenue Code defines a straddle as "offsetting positions with respect to personal property."[24] A "position" is any interest in personal property including futures, forward contracts and options.[25] "Personal property" is any personal property of any type that is actively traded.[26] To meet the "actively traded" requirement, there must be an established trading market for the property such as an option's market.[27] Stock is considered personal property only where the stock is offset by (1) an option on that stock or substantially identical stock or securities, or (2) by a position that is considered to be "substantially similar or related property."[28] Additionally, a taxpayer is treated as holding any position that is held by the taxpayer's spouse or other legal entity filing a consolidated return with the taxpayer.[29]

The straddle rules have two primary components. First, losses on any position that was part of the straddle are deferred to the extent of any unrecognized gains on offsetting positions.[30] Next, interest and carrying charges attributable to a position that are part of the straddle cannot be deducted currently but are capitalized as part of the straddle basis.[31]

The straddle rules create tax character considerations for taxpayers. The rules may prevent property held as part of a straddle from qualifying for long-term capital gain treatment because of the rules' tolling effect to a position's holding period.[32] The only exception to this rule is for property that the taxpayer has held for the long-term holding period prior to entering into a straddle transaction. Therefore, the long-term property will continue to qualify for long-term capital treatment. Conversely, under certain circumstances, the straddle rules may convert what would otherwise be short-term losses into long-term losses.[33]

Exemptions from the straddle rules exist with respect to the application of loss limitations imposed on certain straddles.[34] Here, we are only concerned with the exception for transactions that are undertaken in the normal course of a trade or business with the specific purpose of reducing risk (hedging transactions).[35] Before a trans-

action is defined as a hedging transaction, several conditions must be met: (1) The transaction must be made in the normal course of the taxpayer's trade or business; (2) the purpose for entering into the transaction must be to manage price or currency volatility in relation to underlying hedged property;[36] (3) the gain or loss is treated as ordinary income or loss; and (4) the transaction must be identified as a hedge prior to the close of the business day on which the position is entered into by the taxpayer.[37]

CAVEAT: Tax planner beware: A hedge does not include any transaction entered into by or for a syndicate, which is a partnership or other legal entity (other than a corporation which is not an S corporation) where more than 35 percent of the losses are allocable to limited partners or limited entrepreneurs.[38]

Loss Recognition is Limited

When unwinding a straddle position, losses with respect to one or more positions may be taken into account in any tax year but only to the extent that the losses exceed unrecognized gain resulting from one or more positions that were offsetting those from which the losses resulted.[39] Loss recognition that is limited may be carried over and taken in the next tax year subject to the same recognition limitations.[40]

Where a position offsetting a loss is held at year end, the unrecognized gain is determined as that amount of gain that would be taken into account if the position were sold at fair market value on the last business day of the taxable year.[41] If a gain on such an offsetting position is realized but not recognized, the amount of the unrecognized gain is the amount of gain that has been realized.[42]

Presumed Offset

Under certain circumstances, there is a presumption that two or more positions offset each other.[43] This is unfortunate when a taxpayer planned to use a specific loss against other capital gains. Notwithstanding, this presumption is rebuttal.[44] The presumption arises, (1) when the positions are in the same personal property, whether in the property itself or in a contract for such property regardless of the property's form; (2) the positions are in debt instruments with similar maturities or other debt instruments as described in regulations; or (3) the positions fall within other factors described in regulations as offsetting positions.[45] Lastly, this presumption arises only if the value of one or more of the positions frequently varies inversely with the value of one or more holdings.[46]

A presumption that positions are offsetting also arises if the positions are sold or marketed as offsetting positions (e.g., spread, butterfly, straddle, etc.), or where the aggregate margin requirement for the positions is lower than the sum of the margin requirements for each of the positions if held separately.[47]

Strategies for Circumventing Straddle Rules:

Using a family legal entity, a trust or a younger family member to implement a hedge-like transaction is a useful planning technique provided they do not file a consolidated tax return with the taxpayer. For instance, a family LLC could implement a hedge to protect downturns of a security owned by an older family member. The loss to the older family member reduces their taxable estate, while the gain from the hedge benefits the family LLC. Alternative ownership structures are vast and worth serious consideration by taxpayers and their fiduciaries.

Conclusion: Economics Rule the Decision

Every derivatives transaction requires the taxpayer to ask whether the economics justify the transaction. The goal is not to creative abuses; instead, the goal is for professionals to educate and direct their clients away from unexpected tax pitfalls when using financial derivatives. Moreover, taxpayers need protection from unknowingly creating taxable events or limiting the usefulness of their loss transactions. Where derivatives use is suitable, diligence must be exercised and proper tax planning must also be included in the analysis. Tax consequences require tax planners and taxpayers alike to use great scrutiny to understand all the costs before a derivatives transaction is implemented.

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2. Salih N. Neftci, *Mathematics of Financial Derivatives*, Academic Press, p. xvii, 1996. "Pricing models for financial derivatives require, by their very nature, utilization of a continuous-time stochastic process. A good understanding of the tools of stochastic calculus and of some deep theorems in the theory of stochastic processes is necessary for practical asset valuation."

3. Paul Wilmont, et. al., *The Mathematics of Financial Derivatives*, Cambridge Press, 1996, p. 51. "Hedging is the reduction of the sensitivity of a portfolio to the movements of an underlying asset by taking opposite positions in different financial instruments."

4. Reg. 1-1221-2(b); IRC 1221(b)(2)(A).

5. Pub. L. No. 105-34, § 1001(d), 111 Stat. 788 (1997) (These rules apply to transactions entered into after June 8, 1997).

6. IRC 1259 (c)(1).

7. Reg. 1.1233-1.

8. A put option gives the put holder the right to sell stock at a pre-determined price and time.

9. See supra note 4.

10 A put option is in the money if the strike price is greater than the market price of the underlying security. <http://www.cboe.com/> (last visited July 6, 2003).

11. Out of a concern that stock and stock options were being used to defer gain from one taxable year to the next, Congress decided to target what it deemed abusive transactions that manipulated gain recognition. H.R. Rep. No. 98-432, 98th Cong. 2d Sess. at 1266.

12. R. James French, French Capital Management, Illinois and Colorado (the collar term may go out as far as five years in certain legitimate cases); see also Mark A. Miller, J.D., CFP, "Hedging Strategies for Protecting Appreciation in Securities and Portfolios," 2002, <http://www.fpanet.org/journal/articles/2002_Issues/jfp0802-art7.cfm> (last visited July 19, 2003).

13. Miller *supra* note 11; see also H.R. Conf. Rep. No. 105-220, at p. 514 (1997).

14. Catherine A. Jacobson, Schiff Hardin & Waite, wrote the Treasury on behalf of the Chicago Board Options Exchange, the American Stock Exchange, the Philadelphia Stock Exchange, and the Pacific Stock Exchange requesting the issuance of regulations that would take into account changes in the practices of options exchanges in April of 1995.

15. Randall H. Borkus, "A Trust Fiduciary's Duty To Implement Capital Preservation Strategies Using Financial Derivative Techniques," 36 Real Prop. Prob. & Tr. J. 127, 163, fn. 195, 2001. "A prepaid, forward variable sale is a structured product that allows [a taxpayer] to hedge the equity value while retaining a

portion of the potential capital appreciation, foregoing an immediate tax consequence. The investor retains all the voting rights and dividend payments [of the underlying asset] during the term of the contract."

16. Id. at 164; see also French *supra* note 11.

17. Id.

18. Id.

19. Rev. Rul. 2003-7, 2003-5 I.R.B. 363. (An Agreement does not cause a constructive sale of the shares under § 1259(c)(1)(C) where under the Agreement, the number of shares for delivery, which may vary by as much as 20 percent (between 80 and 100 shares in the ruling), depends on the fair market value of the stock on the Exchange Date. Because the variation in the number of shares to be delivered under the Agreement is significant, the Agreement is not a contract to deliver a substantially fixed amount of property for purposes of § 1259(d)(1) and does not cause a constructive sale under § 1259(c)(1)(C)); see also "Twenty-First Securities, Prepaid Variable Forwards: Off the Hot Plate?", Spring 2003, Vol. VI, Issue 2 <http://www.twenty-first.com /newsletter/newsletter_spring2003-4.htm> (last visited July 26, 2003).

20. See Borkus, supra note 14.

21. H.R. Rep. No. 98-432, 98th Cong. 2d Sess. at 1266; S. Rep. No. 98-169, 98th Cong. 2d Sess. at 288. A typical abusive straddle transaction involved the acquisition of "deep-in-the-money" offsetting option positions. Regardless of whether the value of the underlying stock increased or decreased, one option position resulted in loss that could be realized for tax purposes, while the other option position resulted in gain of approximately equal size that could be deferred until the next year. Id

22. See the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong., 2d Sess., 1984 at 306. (A call is in-the-money to the extent that the exercise price (or strike price) is less than the market value of the stock when the option is granted; a put is in-the-money to the extent the strike price exceeds the stock's value).

23. Id.

24. IRC 1092(c)(1) and (c)(2)(A) (one position does not offset another unless their prices vary inversely so holding one effects a "substantial diminution" of the taxpayer's risk of loss on the other); IRC §1092 (d)(3)(B)(i)(III) and (ii). The straddle rules contain other, more detailed provisions involving futures contracts and corporations formed to enter into hedging strategies.

25. IRC 1092(d)(2).

26. IRC 1092(d)(1).

27. Reg. 1.1092(d)-1(a). (actively traded property includes any personal property for which there is an established financial market such as stocks, options, etc.).

28. IRC 1092(d)(3); see also 1.1092(d)-2(a)(1).

29. IRC 1092(d)(4) (E.g., positions held in a partnership, trust, or other legal entity that are taken into account by the taxpayer are also treated as if held by that taxpayer).

30. IRC 1092(a).

31. IRC 263(g); Amounts not allowed as a deduction are capitalized and added to the basis of the personal property to which the amount relates. IRC 263(g)(1). However, the prohibition on deduction and the requirement of capitalization will not apply in the case of legitimate hedging transactions. IRC 263(g)(3).

32. Reg. 1.1092(b)-2T(a).

33. Reg. 1.1092(b)-2T(b).

34. E.g., §§ Reg. 1.1092(b)-3T and 1.1092(b)-4T the treatment of identified straddles and that of mixed straddles: The loss limitation provisions under IRC § 1092 do not apply if all of the offsetting positions are IRC § 1256 contracts (Mark-to-Market). Provided those contracts do not fall under the IRC § 1256 exceptions and the straddle is not a composite of a larger straddle. See also IRC § 1256(a)(4).

35. IRC § 1092(e).

36. This includes interest rate risk and price or currency swings with respect to debt or other taxpayer obligations. Reg. 1.1221-2.

37. IRC § 1256(e)(2); see IRC § 1221(b)(2)(A).

38. IRC § 1256(e)(3).

39. IRC § 1092(a)(1)(A).

40. IRC § 1092(a)(1)(B).

41. IRC § 1092(a)(3)(A)(i).

42. IRC § 1092(a)(3)(A)(ii).

43. IRC § 1092(c)(3)(A).

44. IRC § 1092(c)(3)(B).

45. IRC § 1092(c)(3)(A).

46. Id.

47. IRC 1092(c)(3)(A)(iv) & (v).

Caution— Is the 412(i) defined benefit plan the right income tax reduction plan for your clients?

By Roccy DeFrancesco, JD

First it was charitable split dollar, then IRC section 419A(f)6 and soon it could be the 412(i) defined benefit plan. Due to very aggressive marketing of the 412(i) plan to agents/brokers and in turn their clients, I was moved to write this article to caution readers about the proper use of a 412(i) plan and what to watch out for when being pitched the plan by aggressive marketers around the country.

A 412(i) plan is a special type of defined benefit pension plan that is funded entirely through annuity or life insurance contracts. A 412(i) plan must follow the same qualification rules as traditional pension plans, including the limits on retirement and death benefits. However, unlike a traditional defined benefit plan, which may be based on five percent to six percent annual invest returns, the 412(i) plan purchases annuities from insurance companies that offer guarantees of two percent or three percent. With a two percent or three percent return guaranteed, the 412(i) plan allows for significantly more in tax deductible contributions annually for the employees.

For example, it is possible for a corporation to contribute $100,000 or more to a 412(i) plan for a 50-year-old employee making more than $170,000 a year.

Who is a good candidate to use a 412(i) plan?

1) Any client over the age of 50 who has little or no money in a qualified plan or IRA (qualified plan being a profit sharing, defined benefit, 401(k) plan, or simple or SEP IRA) who is looking for deductions to a "qualified retirement plan" above the current $40,000 limit with 401k/profit sharing plans.
2) Any client over 50 that is interested large deductions with guaranteed investment products like annuities or life insurance.

If you have clients that own small closely held business that are over the age of 50 with little or no money in a qualified plan, a defined benefit plan (DBP) or 412(i) plan is a very nice option to allow business owners to fund large sums of money tax deductible into a qualified retirement plan.

Problems with traditional 412(i) plans:

1) The more employees a client has,

the less financially viable the topic becomes (especially if the employees are highly compensated and/or older). Because the DBP and 412(i) plans are governed by ERISA, the plans require employers to fund the plans in a non-discriminatory way for the employees. As an example, a 50-year-old owner/employee could have the company contribute $100,000 a year on his/her behalf to a 412(i) plan, but then the company would also have to fund 40 percent more ($40,000) to the plan on behalf of the employees.

2) Clients want more then two to three percent rates of return in their retirement. Deferral for the sake of deferral means very little if the deferred asset grows at a pathetic two to three percent. Most clients would rather pay income taxes on their money and invest it in the market where on average it should return eight percent annually (which will net out a better return than the larger untaxed deferred money at two to three percent rates of return).

Why are so many advisors around the country promoting 412(i) plans?

It is simple—*ease* and *greed*, which are the two downfalls of the insurance and financial planning community. Ease, because the topic is easy to sell from a technical standpoint. The consultant can point to the tax code, and a client's CPA or attorney can read the code and approve the topic. Greed, because the agent can counsel a client to put literally hundreds of thousands of dollars into the plan and, therefore, make commissions.

Just because a topic is easy to sell does not mean that it is a topic an advisor or a client should use for long-term planning. Most agents around the country are being pitched the 412(i) topic by several of the large insurance companies; and, therefore, even an agent who does not do research in the "advanced" tax area is learning about the topic and bringing it to clients.

Out of the normal funding

Financial planners do not make big commissions from annuities; and, therefore, the topic in its traditional form was never that exciting for advisors (and because of the low rates of return, the topic was not that advantageous to clients). Today, companies are getting very aggressive with their planning, and some 412(i) plans are allowing clients to put 100 percent of their contribution to the plan into a particular type of life insurance policy. Conservative consultants dealing with the 412(i) topic will only allow 50 percent of the contributions to a 412(i) plan to be used for the purchase of life insurance.

Promoters are counseling clients to put significant amounts of money in a 412(i) plan into what I call a "sponge" life insurance policy. The sponge policy is the exact type of policy I recommend to help clients avoid the double taxation issue of money in a traditional qualified plan (the client who has $500,000 or more in a qualified plan or IRA, who also has a $3 million + estate).

The life insurance policy literally sucks up the money in a qualified plan like a sponge absorbs water and is specifically designed to have a low cash surrender value (CSV) at the end of the fifth year. At the end of the fifth year of the 412(i) plan, the client will purchase the policy from the 412(i) plan for the low cash surrender value and then wait at least five years before accessing tax free loans from that life policy.

Why in theory is this good? Follow the numbers:

If a client put $250,000 into a 412(i) plan each year for five years as a tax-deductible expense, he/she would have funded $1.25 million dollars over that five-year period. The cash surrender value (CSV) of the policy at the end of the fifth year is approximately $250,000. The client then purchases the life policy from the 412(i) plan for that $250,000 cash surrender value and feels like he/she got a great deal because the cash account value (CAV) of the policy was really $1.1 million. The client then waits for the surrender charges in the life policy to evaporate and takes tax free loans from the policy.

Buying a policy with a low CSV but a high CAV seems like a steal of a deal since the client only paid 1/5th of the value of the asset when purchasing it out of the 412(i) plan. This concept is supposed to save the client 80 percent of the tax on that money. Sound good? While the topic ends up working slightly better than post-tax investing, it pales in comparison to several other topics in the market place.

Real example—Assumption: Client age 50 with no employees who deducts $250,000 a year for five years into a 412(i) plan and corresponding money into the ExTRA Plan, the A/R Factoring Plan, and the Equity Disability Trust. Assume the benefit taken from each plan is from age 60-85.

Outcome:

412(i) Plan—Client could get an income tax free benefit of **$116,552** for 25 years starting at age 60.

Equity Disability Trust (EDT)—Client could get an income tax free benefit of **$143,000** for 25 years starting at age 60.

A/R Factoring—Client could get an income tax free benefit of **$170,673** for 25 years starting at age 60.

ExTRA Plan—Client could get an income tax free benefit of **$178,036** for 25 years starting at age 60.

This example completely ignores the fact that most clients will have employees where the employer, in order to implement a 412(i) plan, will have to fund sometimes tens of thousands of dollars into the plan to allow the key owner to contribute.

A nasty twist to the 412(i) plan

Be aware that some of the five pay life insurance policies (sponge policies) typically used in 412(i) plans have almost no flexibility in payment. By no flexibility, I mean that if for whatever reason a client cannot or does not want to make a premium payment to the 412(i) life policy, there is no way to lower the internal life insurance costs of the policy (without losing substantial cash account value). That means, if the internal cost of insurance in the five-pay policy is $60,000 a year and in year three the client cannot pay a premium, there is no financially viable way to avoid paying that $60,000-a-year premium. The premium will be paid internally from the cash account value of the policy. This will drain the cash value and eventually the policy will surrender itself without more premium from the client.

So, in my opinion, the 412(i) plan is the most inflexible income tax reduction plan in the entire marketplace, and most clients who get into a 412(i) have no idea of the plan's inflexibility.

IRS scrutiny

It is my opinion that the IRS will be looking at the 412(i) topic similar to how it looked at and basically killed

charitable split dollar and 419A(f)6 plans. Big insurance companies are flaunting the tax favorable nature of "sponging" money out of the 412(i) plan with the five pay policies and anytime a national marketing campaign deals with an aggressive tax topic, the IRS always sits up and takes notice.

Conclusion

While a 412(i) plan is a nice option for the right client, for most clients under the age of 60, the 412(i) plan should not be the plan of choice. The 412(i) plan today seems like the right plan because most consultants from around the country do not know any other "advanced" topics and, therefore, are pushing the 412(i) plan. However, when you run the numbers, 9.5 times out of 10 the Equity Disability Trust, A/R factoring plan and, the ExTRA Plan are much better tax topics for physicians who do not require the inclusion of employees when funding.

Roccy DeFrancesco, J.D., is one of the founders of www.triarcadvisors.com, a Web site and company devoted to the education of financial and legal professionals around the country. He is also the author of The Doctor's Wealth Preservation Guide. He can be reached at 269-469-0537 or roccy@wealthpreservation123.com.

Estate and gift tax update

By Kelli E. Madigan, Mathis, Marifian, Richter, & Grandy, Ltd., Belleville

1. PLR 200330028 (April 21, 2003)

Decedent's estate was entitled to an estate tax charitable deduction under §2055(a) equal to the present value of the remainder interest in two trusts reformed under local law pursuant to Reg. §20.2055-2(e)(2). As drafted, the trusts did not qualify for the estate tax charitable deduction because they did not meet the requirements of §2055(e) (3) as charitable remainder unitrusts or charitable remainder annuity trusts.

The judicial proceeding to reform the trust was commenced within 90 days of the due date of the decedent's federal estate tax return. As reformed, each trust provides for quarterly payments equal to 6.25 percent of the net fair market value of the trust assets for the life of the decedent's son, with the remainder paid to charities named in the decedent's initial trust. The son disclaimed any right to distributions in excess of the 6.25 percent unitrust amount. The son's interest in the reformed trust terminates at the same time that his interest would have terminated in the trust as originally drafted and the reformation is effective as of the decedent's death. Based upon the 6.25 percent unitrust payment, the actuarial value of the charitable remainder after the reformation will not differ by more than five percent from the actuarial value of the charitable reminder prior to the reformation; therefore, the proposed reformation satisfies the requirements of §2055(e)(3), and the decedent's estate is entitled to an estate tax charitable deduction equal to the present value of the remainder interest.

2. PLR 200330027 (April 21, 2003)

Decedent's estate was granted an extension of time under Reg. §301.9100 in which to sever a marital trust into a "GST exempt QTIP trust" and a "GST nonexempt QTIP trust" and to make a reverse QTIP election with respect to the GST exempt QTIP trust. Decedent's timely filed Form 706 made a QTIP election with respect to the marital trust created under the decedent's revocable living trust; however, Schedule M did not evidence an intent to sever the marital trust into a GST exempt trust and a GST nonexempt trust. In addition, there was no Schedule R attached to the return to make a reverse QTIP election with respect to any portion of the marital trust.

Upon the death of the decedent's surviving spouse, the error was discovered and a request for extension was made under Reg. §301.9100. Under the regulations, a taxpayer may be granted extension to file certain regulatory or statutory elections provided that the taxpayer give evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interest of the government. The extension was granted, the taxpayer having met the standards provided in Reg. §301.9100-3; however, the extension of time in which to make a reverse QTIP election under §2652(a)(3) did not extend the time in which to allocate any of the decedent's GST tax exemption remaining unused at his death; therefore, the decedent's unused GST tax exemption was to be allocated in accordance with the rules of §2632(e) and §26.2632-1(d)(2).

3. PLR 200328030 (April 4,2003)

The retained right to designate the charitable beneficiaries of a trust rendered a transfer to the charity in a charitable lead unitrust incomplete for gift tax purposes. In addition, the same retained right to designate the beneficiary and the right to amend or revoke the charities by adding or substituting other charities and/or changing the shares of any one more of those charities caused the trust to be included in the settlor's gross estate. Notwithstanding this retained power, the settlor was not treated as the owner of any portion of the trust under §§673, 674, 676 or 677. No ruling was made with respect to §675 as the trust agreement did not contain powers that caused administrative control to be exercisable primarily for the benefit of the settlor. Whether the settlor is treated as the owner under §675 depends on the actual operation of the trust and may not be determined until federal income tax returns of the relevant parties have been examined by the Commissioner.

4. Treasury Decision 9077 (July 17, 2003)

Final gift and estate tax regulations have been issued regarding the disposition of a QTIP qualifying income interest during a lifetime of a surviving spouse. When a surviving spouse disposes of a qualifying income interest in qualified terminable interest property, the amount of the donee spouse's transfer under §2519 is reduced by the amount of the gift tax that the spouse is entitled to recover under §2207A(b) from the recipient of the transferred property. In the event that the donee spouse fails to exercise the right to recover the gift tax, such failure will constitute a gift in the amount of the unrecovered gift tax to the person from whom recovery could have been made under Reg. §25.2207A-1. Finally, in some circumstances, a delay

in the exercise of the right of recovery will be treated as a below-market loan subject to imputation of interest under §7872. Reg. §20.2207A-1; Reg §25.2207A-1 and Reg §25.2519-1.

5. *Estate of Leona Engelman*, CCH DEC. 55,242 (July 24, 2003)

A joint trust was created by husband and wife during their lifetime. Under the terms of the trust, upon the death of the first spouse the trustee was to divide the trust assets into two separate trusts. Trust A was to be funded with all of the assets other than those assets disclaimed by the surviving spouse and Trust B was to be funded with all assets disclaimed by the surviving spouse. The surviving spouse was entitled to all of the income and was granted a testamentary power of appointment over the principal and undistributed income of Trust A. Under Trust B the surviving spouse was entitled to income annually and principal subject to an ascertainable standard. Upon the death of the surviving spouse, the balance of Trust B was to be distributed in the form of specific bequests to certain individuals and charitable organizations.

Following the first spouse's death, the surviving spouse executed a written power of appointment to distribute the balance of Trust A upon her death to certain charitable organizations. This power of appointment was delivered to the trustees just prior to the surviving spouse's death. Following the surviving spouse's death, the special administrator of her estate attempted to disclaim a portion of the property of the joint trust in order to fund Trust B. The Ninth Circuit concluded that the operation of the written power of appointment over the assets in Trust A constituted the surviving spouse's acceptance of the property and consequently the subsequent disclaimer by the special administrator was not a qualified disclaimer under §2518.

Tax administration and procedure update

By Thomas F. Arends, Richard M. Colombik and Assoc., P.C., Schaumburg

Introduction

The editorial staff of the newsletter would like to inform members of the Federal Taxation Section that Mr. Thomas Arends and Mr. William Gasa of the Section Council currently serve as liaisons for the Section to the Internal Revenue Service. Any questions or concerns that you may have on tax practice issues or representation before the IRS can be directed to their attention for discussions at future IRS liaison meetings. Mr. Arends can be reached by e-mail at tarends@colombik.com and Mr. Gasa can be contacted at wmgasaltd@aol.com.

Included in this update are select announcements that we have received from our IRS liaison contacts in the Mid-States Region. We will continue to provide in this newsletter select announcements on procedure and administrative issues that we feel are of interest to Section members.

IRS works to reduce taxpayer burden

The Internal Revenue Service (IRS) has long recognized that the tax system places great burden on taxpayers. Taxpayers have to spend time and money to make sure they file all required returns in a correct and timely manner. Because reducing that burden is a top priority for the IRS, it established the Office of Taxpayer Burden Reduction (OTBR) in January of 2002.

OTBR develops and implements burden reduction initiatives by listening to and working with a variety of organizations, which include Congress, other groups within the IRS, state and federal agencies, taxpayers, tax practitioners, and industry, trade and professional organizations.

OTBR is involved in IRS initiatives to simplify forms, to write less burdensome rulings, regulations and laws, and to simplify recordkeeping requirements in the tax law.

OTBR has a presence throughout the country. Tax specialists in the Taxpayer Education and Communication (TEC) organization of the IRS are working with local organizations to identify burden reduction issues and with taxpayers and practitioners to develop the issues in a way that will garner attention at the national level and provide a base of information to support the effort.

A number of burden reduction initiatives led by OTBR have already resulted in savings to taxpayers. For example, by raising the minimum requirement for filing a Form 1040, Schedule B (Interest and Ordinary Dividends) from $400 to $1500 of interest and dividend income, 15 million taxpayers no longer are required to file a Schedule B with their Income Tax Returns.

Employers and the payroll service industry have also benefited. IRS has changed the problem resolution procedures for electronic payments received from payroll services. The new process makes it much easier for the payroll services and the IRS to correct electronic payment errors before the IRS assesses any penalties. This saves time and money for the payroll services and the thousands of businesses who would receive the penalty notices if the errors are not corrected.

The Industry Issue Resolution (IIR) Program is another major effort to reduce taxpayer burden. The purpose of the IIR program is to resolve frequently disputed or burdensome business tax issues within an industry through published legal or administrative guidance. Industries submit the issues to the IIR program. If the program accepts an issue, the impacted industry provides information explaining why the existing IRS guidance for the issue is unclear, difficult to follow, or applied inconsistently by the IRS during the audit process.

A team of experts from IRS and the Department of the Treasury use industry input and work together to find a solution to the proposed issue that meets the requirements of the law and meets the needs of the business taxpayers.

A number of projects have already met with success and an enthusiastic reception from the industries impacted. For example, Revenue Procedure 2003-22 was issued as a result of the IIR program. The Revenue Procedure allows those providing day care in their homes to use a "per diem" option for meals and snacks provided to each child, thus reducing the record keeping burden by an estimated 10 million hours.

In his testimony before Congress in

April 2003, Robert E. Wenzel, then Acting Commissioner of the Internal Revenue Service, summed up the state of burden reduction when he said, "Clearly, we have made some progress, but clearly too, reducing unnecessary taxpayer burden in all its many shapes and forms is an enormous challenge, especially when seen within the context of an extremely complex and ever-changing Tax Code." With the public's help, OTBR and TEC tax specialists nationwide are ready to meet these challenges.

Additional information about taxpayer burden reduction is available on the IRS Web site at <http://www.irs.gov>.

Treasury issues rules to increase transparency and halt abusive tax avoidance transactions—Reins tightened on lawyers, accountants, and other tax advisors

On December 29, 2003 the Treasury Department and the IRS issued four items of administrative guidance as part of their ongoing effort to halt abusive tax avoidance transactions and maximize effective use of IRS audit resources. The first of the items released is aimed at strengthening the tax system through heightened standards for tax advisors. The other three are aimed at increasing transparency and disclosure of information to the IRS. Improved disclosure coupled with more effective use of the information disclosed are central to the Treasury Department and IRS' strategy for identifying abusive tax avoidance transactions early and addressing them promptly. In addition, the transparency that disclosure brings serves as a deterrent to abusive tax avoidance transactions.

> "Taken together, the actions we are announcing … represent another significant step to end the proliferation of abusive tax avoidance transactions that has undermined confidence in our tax system," said Treasury Assistant Secretary for Tax Policy Pam Olson. "We are proposing a set of best practices that makes clear that tax professionals should adhere to the highest ethical standards and ensure that their clients are well-advised of the law and any risks they are taking."

- **Proposed changes to Circular 230 that set high standards for the tax advisors and firms that provide opinions supporting tax-motivated transactions.**
  - √ The proposed rules set out clear and specific requirements for tax opinions provided by attorneys and accountants and expectations for those with supervisory responsibility for a professional services firm's tax practice.
  - √ In an effort to halt the rush to the bottom that pervaded the 1990s and restore the confidence of the public in tax professionals, the proposed changes also describe best practices for tax advisors and call on professional services firms to put in place procedures for all of the firm's personnel that are consistent with these best practices.
  - √ To ensure clients are well-advised, the proposed changes would obligate tax advisors to inform clients explicitly about what protections, if any, an opinion provides to the client. For example, tax advisors would have to advise clients about issues that the opinion does not address and warn the client if the opinion will not protect the client against penalties.
  - √ The Treasury Department and the IRS are working with professional organizations to promote best practices among tax professionals through setting aspirational standards and self-regulation. The proposed changes would put in place a framework for that effort.
  - √ The proposed changes replace changes proposed in January 2001. They reflect a careful consideration of the comments received on the January 2001 proposals and information gathered by the IRS in its audit of professional services firms' compliance with the tax shelter rules.

- **Final regulations that will increase the cost of failing to disclose abusive tax avoidance transactions.** The regulations also apply to taxpayers who do not disclose that they have reported items on their tax returns that are based on the position that a Treasury regulation is invalid. Under the final regulations, for purposes of the imposition of penalties, a taxpayer's failure to disclose an abusive tax avoidance transaction is treated as a strong indication that the taxpayer acted in bad faith with respect to any additional tax owed as a consequence of the transaction. Similarly, taxpayers who do not disclose items that are based on advice that a Treasury regulation is invalid will be deemed to have acted in bad faith with respect to any additional tax that is owed as a consequence of those items.

"We are taking the administrative steps we can under current law to create downsides for those who choose not to disclose by making it clear that failing to disclose significantly increases the likelihood of penalties being imposed," continued Assistant Secretary Olson. "Having the IRS hunt for an abusive transaction hidden on a tax return is a waste of IRS resources. If a taxpayer is willing to enter into a transaction, then the taxpayer should be willing to disclose that transaction on its return."

- **Revised final regulations clarifying that the disclosure of confidential transactions on a return is limited to transactions for which a promoter has imposed confidentiality on a taxpayer to protect the promoter's tax strategies from disclosure.** The revisions are intended to reduce unnecessary paperwork for taxpayers and advisors and to allow the IRS to focus its attention on transactions with potential for abusive tax avoidance, not on transactions for which confidentiality is required for non-tax reasons.

"We continue to believe that sunshine is the best disinfectant for abusive transactions," noted Assistant Secretary Olson." "Ensuring that the rules are focused appropriately on the transactions with potential for abusive tax avoidance will further that goal. Burdening taxpayers and burying the IRS with useless paper will not. As a consequence, we have narrowed the disclosure of confidential transactions to situations in which the promoter imposed confidentiality to keep the promoter's tax strategy out of view."

- **Proposed new Form 8858 requiring information reporting by U.S. persons that own for-**

eign entities that are disregarded for U.S. tax purposes. The need for information is not limited to the area of abusive tax avoidance transactions. Appropriately tailored disclosure and information reporting requirements provide the means to better focus the audit resources aimed at protecting the integrity of our tax system. Ready access to information allows the IRS to identify potential compliance issues efficiently and is critical to achieving the IRS' commitment to reducing the time needed to complete an audit. The proposed Form 8858 will be required for annual accounting periods beginning after December 31, 2003. Comments on the text of the proposed new Form 8858 are requested from the public by March 1, 2004.

"Lack of information increases the time it takes for the IRS to identify and address potential compliance issues efficiently and effectively," Assistant Secretary Olson stated. "The proposed new form will increase transparency for offshore entities, allowing the IRS to better focus its resources and improve compliance. The disclosure will also have a deterrent effect."

The Treasury Department has adopted measures that do as much as possible to stem abusive tax avoidance transactions without legislative change. We urge Congress to pass the legislation of the Treasury Department and Secretary Olson.

Bills on Request

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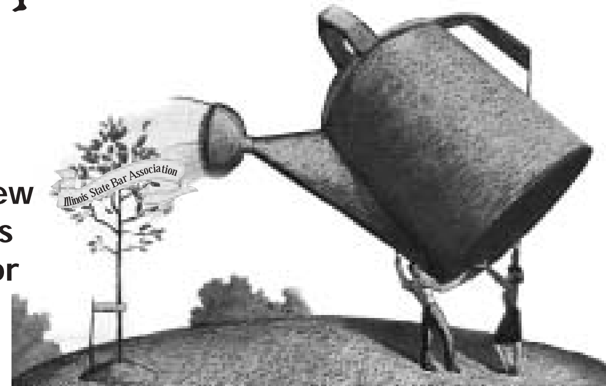

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